Petition

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81-845

CASE NO.

in the

Supreme Court

of the

United States

October Term, 1981

INVESTORS TAX SHELTERED
REAL ESTATE, LIMITED,
Petitioner,

vs.

HALLMARK GROUP COMPANIES, INC., and
PACIFIC WESTERN MOBILE HOME
ESTATES, INC.,
Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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Jesse C. Jones
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October 30, 1981

QUESTION PRESENTED

WHETHER A MISSTATEMENT OF FINANCIAL CONDITION MADE WITH A RECKLESS DISREGARD FOR THE TRUTH AND WITH AN INTENT TO INDUCE RELIANCE SATISFIES THE INTENT REQUIREMENT OF SECTION 17a(2) OF THE BANKRUPTCY ACT.

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OPINION BELOW

The opinion below is not reported (but is included in the appendix).

JURISDICTION

The United States Court of Appeals for the Ninth Circuit entered its decision May 15, 1981, and denied rehearing (and a suggestion of rehearing en banc) August 3, 1981.

This petition for writ of certiorari is filed pursuant to 28 U.S.C. §1254(1) (1976).

STATUTORY PROVISION INVOLVED

11 U.S.C. §35(a)(2) (1976):

A discharge in bankruptcy shall release a bankrupt from all of his provable debts, whether allowable in full or in part, except such as . . . (2) are liabilities for obtaining money or property by false pretenses or false representations, or for obtaining money or property on credit or obtaining an extension or renewal of credit in reliance upon a materially false statement in writing respecting his financial condition made or published or caused to be made or published in any manner whatsoever with intent to deceive, or for willful and malicious conversion of the property of another.

STATEMENT OF THE CASE

Subsequent to obtaining a Chapter XI discharge, Hallmark Group Companies, Inc., and Pacific Western Mobile Home Estates, Inc., (collectively, "Hallmark") sued Investors Tax Sheltered Real Estate, Ltd., a Florida limited partnership ("Investors"), seeking discharge[1] of Investors' judgment in the amount of $2,289,204. Investors lawfully obtained that judgment when Hallmark defaulted on a guarantee of one of its subsidiary's obligations under a sale/leaseback agreement. Investors had entered that arrangement in express, undisputed, and deliberately-induced reliance on Hallmark's 1971 financial statement, which overstated Hallmark's assets by more than $14,000,000.

Investors defended Hallmark's complaint based on Bankruptcy Act Section 17a(2), which excepts from discharge certain debts obtained in reliance on false financial statements.[2]

The bankruptcy court found all the requisite elements of Section 17a(2) except *scienter*:

> The plaintiff's decision to enter into the sale/leaseback arrangement with U.S. Capital Company was based in part on the reliance which it placed on Hallmark's consolidated balance sheet which exaggerated the value of

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[1]Hallmark had failed to list Investors as a creditor in the Chapter XI proceeding.

[2]11 U.S.C. §35(a)(2) (1976). This provision has been replaced by 11 U.S.C. §523(a)(2).

> its assets . . . . False pretenses or misrepresentations which give rise to a non-dischargeable debt must be shown to have been knowingly made to a creditor, and must involve moral turpitude, and the fraud must be express. For a debt to be excepted from discharge pursuant to the section under consideration it must arise because of actual fraud, rather than that implied in law. . . . There is no evidence of such express intent . . . .

The bankruptcy court therefore held the debt discharged.

The district court affirmed. It confirmed the bankruptcy court's finding that Hallmark's financial statement "contained omissions of material information and greatly exaggerated the value of its assets." The district court also agreed, however, with the bankruptcy court's conclusion that Investors had not established the requisite intent. The district court expressly held that a statement made with reckless disregard for the truth and with the intent to induce reliance does not satisfy the *scienter* requirement of Section 17a(2).

The Ninth Circuit affirmed on the same ground. That court held (1) that a reckless misstatement with intent to induce reliance—as opposed to a reckless misstatement with intent to deceive—does not satisfy Section 17a(2) as previously construed by a different panel of the same court in *In Re Houtman*, 568 F.2d 651 (9th Cir. 1978); (2) that the lower courts' supposed finding (*sub silentio*) that there was no "intent to induce reliance"

was not "clearly erroneous;" and (3) that Investors' proof that the financial statement was false did not establish a *prima facie* case under Section 17a(2).

REASONS FOR ALLOWING THE WRIT

Section 17a(2) of the Bankruptcy Act excepts from discharge "liabilities . . . for obtaining money . . . in reliance upon a materially false statement in writing respecting [the debtor's] financial condition made or published or caused to be made or published in any manner whatsoever with intent to deceive. . . ."

As with similar statutes, the lower courts have struggled with the meaning of "intent to deceive." Until recently, most courts concluded that actual, express fraud—as opposed to legal or constructive fraud—was required.[3]

The Ninth Circuit pioneered the departure from this restrictive reading. *In Re Houtman*, 568 F.2d 651 (9th Cir. 1978). The court there held that the knowledge requirement of Section 17a(2) is satisfied by a reckless disregard for the truth; a knowing misstatement need not be shown.

The Seventh and Fifth Circuits have followed *Houtman*. *Carini v. Matera*, 592 F.2d 378, 380 (7th Cir. 1979) ("Indeed where, as here, a person knowingly or recklessly makes a false representation which the person knows or should know, will induce another to make a

[3]*See e.g.*, In Re Taylor 514 F.2d 1370 (9th Cir. 1975); Sanitation Recycling Inc. v. Jay Peak Lodging Ass'n, Inc., 428 F.Supp. 1022 (D. Vt. 1977); In Re Knight, 421 F.Supp. 1387 (M.D. La. 1976).

loan, intent to deceive may logically be inferred."); *Matter of Bardwell*, 610 F.2d 228, 229 (5th Cir. 1980) ("Obtaining credit by a materially false statement will prevent bankruptcy discharge if the bankrupt either had actual knowledge of the falsity of the statement or demonstrated reckless indifference to the accuracy of the facts stated therein.").

Any requirement purportedly more stringent—drawing any supposed distinction between "intent to deceive" and "a reckless misstatement with intent to induce reliance"—would be contrary to the logic and weight of the law. As stated in *Prosser*, Torts §107 pp.700-01 (4th ed. 1971):

> The intent which becomes important is the intent to deceive, to mislead, to convey a false impression. Obviously, this intent, which has been given the name of "*scienter*" by the courts, must be a matter of belief, or absence of belief, that the representation is true . . . . There is of course no difficulty in finding the required intent to mislead where it appears that the speaker believes a statement to be false. Likewise there is general agreement that it is present when the representation is made without any belief as to its truth, or with reckless disregard whether it be true or false . . . . A defendant who asserts a fact as of his own knowledge or so positively as to imply that he has knowledge, under circumstances where he is aware that he will be so understood when he knows that he does not in fact know whether what he says is true, is found to have

the intent to deceive, not so much as to the fact itself, but rather to the extent of his information.

This Court expressly reserved ruling on this same question under Section 10 of the Securities Exchange Act of 1934[4] in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n. 12 (1976). Since then, the lower courts that have considered the question generally have accepted the "recklessness" standard.[5]

To hold, as the courts below have done, that a debt created in deliberately-induced reliance on a reckless misstatement of financial condition is discharged, is improperly to turn bankruptcy into a sanctuary for scoundrels.

The Ninth Circuit purported also to defer to the lower courts' supposed factual finding that there was no "intent to induce reliance"; however, the lower courts in fact made no finding on intent,[6] because they held

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[4]U.S.C. §78j(b) (1976).

[5]*See, e.g.*, Broad v. Rockwell Int'l. Corp., 642 F.2d 927 (5th Cir. 1981); Mansback v. Prescott, 598 F.2d 1017 (6th Cir. 1979); Nelson v. Serwold 576 F.2d 1332 (9th Cir. 1978); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38 (2d Cir. 1978); Coleco Indus. Inc. v. Berman, 567 F.2d 569 (3d Cir. 1977); Sunstrand Corp. v. Sun Chem. Corp. 553 F.2d 1033 (7th Cir. 1977).

[6]The bankruptcy court in fact held:

> The plaintiff's decision to enter into the sale and leaseback arrangement with U.S. Capital Company was based in part on the reliance which it placed on Hallmark's consolidated balance sheet which exaggerated the value

intent to induce reliance would not suffice. Moreover, the fact findings were based on an erroneous legal standard, and the "clearly erroneous" rule is therefore inapplicable.[7]

The question is ripe for review, and is squarely presented in this case.

CONCLUSION

For these reasons, the Court should grant the petition for writ of certiorari.

Respectfully submitted,

Guy B. Bailey, Jr., and
Jesse C. Jones,
Counsel of record for
Petitioner

(Footnote 6 Continued)

> of its assets. . . . The defendant Hallmark's financial statement . . . was presented to the plaintiff as a part of the sale/lease back transaction . . . .

[7]*See* NLRB v. Alterman Transp. Lines, 587 F.2d 212 (5th Cir. 1979); Morvant v. Constr. Aggregates Corp., 570 F.2d 626, 634 n. 11 (6th Cir. 1978), *cert. denied*, 439 U.S. 801 (1978); Travelers Indem. Co. v. United States, 534 F.2d 71, 73 (9th Cir. 1976); Nader v. Allegheny Airlines, 512 F.2d 527 (D.C. Cir. 1975); American Plan Corp. v. State Loan & Fin. Corp., 365 F.2d 635 (3d Cir. 1966).

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[FILED MAY 15 1981]

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 79-4789
D.C. No. 79-0001

In re: Hallmark Group Companies, Inc., and Pacific Western Mobile Home Estates, Inc.,
Plaintiffs-Appellees,

vs.

Investors Tax Sheltered Real Estate, Limited,
Defendant-Appellant.

Appeal from the United States District Court
for the Northern District of California
William H. Orrick, District Judge, Presiding
Argued and submitted April 16, 1981

MEMORANDUM

Before: Tang and Nelson, Circuit Judges, and Craig,* District Judge

Investors Tax Sheltered Real Estate Limited [Investors] appeals from a district court decision upholding a bankruptcy court decision that a debt owed by Hallmark Group Companies, Inc. [Hallmark] was properly discharged. We affirm.

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*The Honorable Walter E. Craig, Senior United States District Judge, District of Arizona, sitting by designation.

Investors raises two arguments in support of its claim that Hallmark's debt should have been excepted from discharge under Section 17a(2) of the Bankruptcy Act, 11 U.S.C. §35(a)(2) (1976) (statute applicable to this case). First, it argues that the case should be reversed because the district court incorrectly read *In re Houtman*, 568 F.2d 651 (9th Cir. 1978) not to hold that a false statement made with reckless disregard of truth and with the intent to induce reliance satisfies the intent requirement of 17a(2). We think that the district court was correct in its statement that this was not the holding of *Houtman*, which was concerned with whether "reckless disregard" satisfied the requirement that the debtor knew the statements were false at the time he made them. What is more important, however, is that the district court only used the term "intent to induce reliance" in framing Investors' legal argument—neither the district court nor the bankruptcy court found such an intent to induce reliance as a factual matter, much less the required intent to deceive. Investors has not cited to this court evidence in the record that would even tend to establish that the lack of such findings was clearly erroneous. Without proof of this intent to deceive, Investors fails to meet the five part test this Circuit has required for exemption under 17a(2). *See In re Taylor*, 514 F.2d 1370, 1373 (9th Cir. 1975).

Investors next argues that, because it set forth a *prima facie* case of fraud, the district court should be reversed. This argument assumes that a *prima facie* case of fraud has been established here, when all that has been shown are exaggerations in a financial statement not prepared in conjunction with this transaction.

Investors cannot avoid the crucial lack of a showing of intent to deceive by such an argument.

AFFIRMED.

[FILED AUG 3 1981]

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 79-4789
D.C. # 79-0001

In re: HALLMARK GROUP COMPANIES, INC., and PACIFIC WESTERN MOBILE HOME ESTATES, INC.,
Plaintiffs-Appellees,

v.

INVESTORS TAX SHELTERED REAL ESTATE, LIMITED,
Defendant-Appellant.

ORDER

Before: TANG and NELSON, Circuit Judges, and CRAIG,* District Judge

The panel as constituted in the above case has voted to deny the petition for rehearing and to reject the suggestion for a rehearing en banc.

The full court has been advised of the suggestion for an en banc hearing, and no judge of the court has requested a vote on the suggestion for rehearing en banc. Fed. R. App. P. 35(b)

The petition for rehearing is denied and the suggestion for a rehearing en banc is rejected.

*Honorable Walter E. Craig, Senior United States District Judge, District of Arizona, sitting by designation.

[FILED OCT 4 1979]

IN THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF CALIFORNIA

CASE NO. C-79-0001-WHO

HALLMARK GROUP COMPANIES, INC., a New York corporation,

Debtor,

PACIFIC WESTERN MOBILE ESTATES, INC., a Delaware corporation, debtor,

Plaintiffs and Appellees,

vs.

INVESTORS TAX SHELTERED REAL ESTATE LTD., et al.,

Defendants and Appellants.

JUDGMENT

The above entitled matter came on for final hearing on May 25, 1979. It was an appeal from a Judgment of the Bankruptcy Court entered on November 16, 1978, by the Honorable WARREN C. MOORE, Bankruptcy Judge. GUY B. BAILEY, JR., appeared on behalf of the Appellant-Defendant, INVESTORS TAX SHELTERED REAL ESTATE, LTD., and THOMAS C. THOMPSON appeared for the Appellee-Debtors above named. Based upon the record, the briefs, and oral argument submitted herein, the court finds that:

1. The Appellee obtained a discharge of its debts in November of 1975. The Bankruptcy Court mailed out notices to all scheduled creditors which confirmed the plan of arrangement filed therein.

2. The Appellant, who is a substantial creditor of the Plaintiff, claims that its debt was not discharged, because it was excepted pursuant to 11 U.S.C., Section 35 (A)(2), Section 17(A)(2) of the Bankruptcy Act.

3. The Bankruptcy Court held that Appellant did not produce evidence showing that Appellee had the requisite intent to deceive, and therefore held the debt discharged.

4. Appellant argues that *In Re Houtman*, 568 Fed 2d 651 (9th Circuit 1978) holds that a statement made with a reckless disregard for the truth and with the intent to induce reliance satisfies the intent requirement of the statute. This Court holds that such is not the case, because the *In Re Houtman* Court discussed "reckless disregard" in regard to the requirement that the debtor knew the statements were false at the time that he made them.

5. The Appellant further argues that the Bankruptcy Court erred in finding that there was no evidence that the debtor made the representation with the fraudulent intent and purpose of deceiving the creditor. The testimony cited by Appellant shows that Appellee's Financial Statement contained omissions of material information and greatly exaggerated the value of its assets. This court finds that, under any standard of review, the record contains no evidence at all of fraudulent intent.

6. This Court needs not and does not reach the issues of whether or not the parties hereto stipulated to the introduction into evidence in the court below of that certain Florida Transcript, or of whether Appellant's claim of nondischargability was untimely.

NOW, THEREFORE, THE COURT ORDERS: That the Judgment of the Bankruptcy Court entered on Novem[illegible]r 16, 1978, be and it is hereby affirmed in all respects.

DATED: Oct 3 1979

William H. Orrick
JUDGE OF THE
UNITED STATES DISTRICT

[FILED AUG 12 1977]

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA

Bankruptcy No. 574-791-M
Bankruptcy No. 574-792-M
CONSOLIDATED

In re

HALLMARK GROUP COMPANIES, INC.,
a New York corporation, Debtor,

PACIFIC WESTERN MOBILE ESTATES, INC.
a Delaware corporation, Debtor,
Plaintiffs,

vs.

INVESTORS TAX SHELTERED
REAL ESTATE LTD., DOE ONE,
DOE TWO and DOE THREE, inclusive,
Defendant,

ORDER

HALLMARK, the plaintiff in this dispute, is also the debtor in a Chapter XI arrangement proceeding that was confirmed in this court. It asks that the defendant, INVESTORS TAX SHELTERED REAL ESTATE LTD., be restrained from attempting to recover from the plaintiff any claim which it now or in the future may have, upon the grounds that it is bound by the discharge contained in the order of confirmation.

There is presently pending in the state court of Florida, a suit for damages by the defendant here against a firm of accountants, LAVENTHOL, KREKSTEIN, HORWATH & HORWATH, upon the grounds that that agency furnished false financial information provided by a subsidiary of HALLMARK, which the plaintiff there and the defendant here relied upon to its damage.

In addition, the defendant here obtained a judgment against the plaintiff here in a non-contested proceeding in the state court of Texas shortly after the confirmation of the Chapter XI plan by this court.

The issues then, before the court are:

1. May this court interfere with a state court proceeding in Florida if there is the possibility that the prevailing party there might attempt to satisfy its judgment by recovery from HALLMARK's subsidiary.

2. May the plaintiff in the Texas suit be restrained from attempting to collect its judgment against HALLMARK, as judgment debtor, upon the grounds that it would be seeking to assert a claim as a creditor after the time has expired within which to file claims in the Chapter XI proceeding. Bankruptcy Rule 11-33(b)(2). Bankruptcy Act 17a(3).

Counsel for defendant INVESTORS TAX SHELTERED REAL ESTATE LTD., has stipulated that it will proceed in this court in the event of any future attempt to assert any claim it may have against HALLMARK.

The facts upon which the present litigation arises are as follows:

1. HALLMARK filed a petition for relief under the provisions of Chapter XI of the Bankruptcy Act on April 8, 1974 and thereafter submitted a Plan of Arrangement which was confirmed by this court on October 8, 1975. Notice of Confirmation was duly mailed by the clerk of the Court as required by law on November 14, 1975.

2. The defendant, INVESTORS TAX SHELTERED REAL ESTATE LTD. was not listed as a creditor by the debtor in its schedules and has never filed a claim in the arrangement proceeding. It admits knowledge of the Chapter XI proceeding not later than November 6, 1975.

3. Before the hearing on confirmation in the Arrangement proceeding the defendant in this action filed a suit for damages against LAVENTHOL, KREKSTEIN, HORWATH & HORWATH, an accounting firm, in the state court of Florida.

4. The basis for the Florida suit, as stated above, involves erroneous financial information having to do with U. S. CAPITAL CORPORATION, which the latter provided to its accountants, named above, who in turn provided it to INVESTORS TAX SHELTERED REAL ESTATE LTD., and which the plaintiff in that action contends was relied upon to its damage. U. S. CAPITAL CORPORATION is a subsidiary of HALLMARK, which is not a party to that suit.

5. Shortly after the Order of Confirmation was entered in the Chapter XI proceeding, the defendant here obtained a judgment for $2,500,000.00 against HALLMARK in a non-contested action in the state court in Texas. A record of that case will be provided this court to be considered in its decision.

It has been stipulated by counsel for both parties in the present controversy that the issues raised by the pleadings may be decided by the court based upon the existence of the above facts and it is therefore

ORDERED that the litigation between the parties herein, HALLMARK and INVESTORS TAX SHELTERED REAL ESTATE LTD. may be submitted to the court for its decision after each party has had the opportunity to submit points and authorities in support of each position.

Dated this 12 day of August, 1977.

WARREN C. MOORE

WARREN C. MOORE
Bankruptcy Judge

[FILED AUG 30 1977]

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA

Bankruptcy No. 574-791-M
Bankruptcy No. 574-792-M
CONSOLIDATED

In re

HALLMARK GROUP COMPANIES, INC.,
a New York corporation, Debtor,

PACIFIC WESTERN MOBILE ESTATES, INC.
a Delaware corporation, Debtor,
Plaintiffs,

vs.

INVESTORS TAX SHELTERED
REAL ESTATE LTD., DOE ONE,
DOE TWO and DOE THREE, inclusive,
Defendants.

AMENDED ORDER

The hearing in the above matter having been held on August 8, 1977; an order having been entered on August 12, 1977; a request having been made by GERALD C. VANOLI, Esq., on behalf of the Plaintiffs herein to amend said order; and good cause appearing therefore, the order entered on August 12, 1977 is hereby amended as follows:

1. Page 2, line 3 and 4 ". .shortly after the confirmation of the Chapter XI plan by this court." is changed to ". .some time in June of 1974".

2. Page 3, line 13 "Shortly after the Order of Confirmation was entered in the Chapter XI proceeding, . ." is changed to "Some time in June of 1974. ."

3. Page 2, line 32 ". .November 6, 1975." is changed to read ". .the end of June of 1974."

Dated this 30 day of August, 1977.

WARREN C. MOORE

WARREN C. MOORE
Bankruptcy Judge

[FILED OCT 14 1977]

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA

Bankruptcy No. 574-791-M
Bankruptcy No. 574-792-M
CONSOLIDATED

In re

HALLMARK GROUP COMPANIES, INC.,
a New York corporation,

PACIFIC WESTERN MOBILE ESTATES, INC.,
a Delaware corporation,

Plaintiffs,

vs.

INVESTORS TAX SHELTERED
REAL ESTATE LTD., DOE ONE,
DOE TWO and DOE THREE, inclusive,

Defendants,

MEMORANDUM OF DECISION AND ORDER

HALLMARK has filed a complaint asking for relief against the Defendant, INVESTORS TAX SHELTERED REAL ESTATE LTD., in the form of an order restraining it from proceeding against another entity on a claim for damages in the State Court of Florida.

The action in Florida concerns ITSREL's claim as Plaintiff against an accounting firm, LAVENTHOL,

KREKSTEIN, HORWATH & HORWATH, and the cause of action for damages against that Defendant in which it alleges that the latter provided it with false information which it relied upon to its damage.

The same Defendant in this proceeding obtained a judgment in the Texas State Court against HALLMARK, who questions the validity of that judgment as well as its liability. HALLMARK is a debtor in this consolidated proceeding and the parent company of PACIFIC WESTERN MOBILE ESTATES.

At a Pre-Trial hearing, it was stipulated by the Defendant in this action, INVESTORS TAX SHELTERED REAL ESTATE LTD, known as ITSREL, that any attempt which it might make to satisfy the Texas State Court judgment may be pursued in this court, therefore, the only issue presently before this Court concerns its jurisdiction to restrain ITSREL from proceeding in a suit for damages in the Florida State Court against LAVENTHOL, KREKSTEIN, HORWATH & HORWATH.

Section 2 of the Bankruptcy Act (11 U.S.C. §11) is the basic section which confers jurisdiction upon a Bankruptcy Court. An examination of that section does not show that this Court has jurisdiction to interfere in a damage suit between two parties, neither of whom is a party to an action, dispute or litigation in the Bankruptcy Court.

IT IS THEREFORE CONCLUDED that this Court lacks jurisdiction to grant the relief requested by the Plaintiffs as to the Florida State Court proceeding involving ITSREL and LAVENTHOL, KREKSTEIN, HORWATH & HORWATH.

IT IS THEREFORE ORDERED that the relief requested by the Plaintiffs be denied as to that litigation and that that portion of the Plaintiffs' complaint be dismissed.

IT IS FURTHER ORDERED pursuant to the stipulation made on behalf of ITSREL that jurisdiction to determine the validity of any claim by ITSREL against HALLMARK resulting from a judgment entered in its favor in the State Court of Texas be reserved for hearing in this Court at a future date to be fixed by order of this Court, subject to both parties being so notified.

Signed in San Jose, California, in said District this 14 day of October, 1977.

WARREN C. MOORE

WARREN C. MOORE
Bankruptcy Judge

[FILED NOV 8 1978]

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA

Bankruptcy No. 574-791-M
574-792-M

(CONSOLIDATED)

In re:

HALLMARK GROUP COMPANIES INC., a New York corp.,

Debtor,

PACIFIC WESTERN MOBILE ESTATES, INC., a Delaware corp.,

Plaintiffs,

vs.

INVESTORS TAX SHELTERED REAL ESTATE LTD., DOE ONE, DOE TWO, and DOE THREE, Inclusive.,

Defendants,

MEMORANDUM DECISION

The plaintiff, a Florida limited partnership, bought an apartment building in Dallas, Texas from the U.S. CAPITAL CO., to whom the building was leased back as a part of the same transaction. The lease, which was to run for nine years, was guaranteed by the defendant,

the lessee's parent company. In deciding to make the investment which culminated in the sale and leaseback, the financial report of the defendant as guarantor, which had been prepared about a year before the deal, was considered. About a year after the leaseback, the defendant filed an Arrangement Petition in this court and no more lease payments were received from U.S. CAPITAL CO.

The plaintiff's decision to enter into the sale-leaseback arrangement with U.S. CAPITAL CO., was based in part on the reliance which it placed in HALLMARK'S consolidated balance sheet which exaggerated the value of its assets and it is urged that the presentation of such a document was a fraudulent act under the provisions of *Bankr. Act.* §17a(2) which would make the guaranty of HALLMARK for the lease payments of its subsidiary to the plaintiff a non-dischargeable obligation. In an effort to recover damages for this alleged misconduct from the defendant, it started a lawsuit in Texas that has been restrained by the automatic restraining order which takes effect in every Arrangement Proceeding. The plaintiff, although not listed as a creditor, conceded that it had knowledge of the Arrangement Proceeding but did not file a claim in this court. *Bankruptcy Rule* 11-33 requires that an unscheduled creditor must file his claim before confirmation of a Plan of Arrangement and the court is therefore without jurisdiction to allow the proof of such a claim after that time has passed, which has happened in the present case. Since the issue of the allowance of a late claim is settled because of such lapse of time, the only remaining issue concerns the question of whether or not HALLMARK'S guaranty given to the plaintiff can be excepted from its discharge by reason of the alleged misleading consolidated balance sheet.

If the plaintiff's claim against the defendant, HALLMARK, parent company of U.S. CAPITAL CO., can be excepted from a discharge, contained in the confirmation of its Plan of Arrangement, it must have arisen out of circumstances contemplated by the provisions of *Bankr. Act.* 17a (2) dealing with situations where money or property has been obtained by false pretenses or false representations: None are found to exist in the present case.

False pretenses or misrepresentations which give rise to a non-dischargeable debt must be shown to have been knowingly made to a creditor, *Baash-Ross Tool Co., v. Stephen* 73 F. 2d 902 and must involve moral turpitude. *Hisey v. Lewis-Gall Hospital* 27 F. Supp 20 and the fraud must be express, *Sanger v. Burnett* 221 S.W. 1087. For a debt to be excepted from a discharge pursuant to the section under consideration it must arise because of actual fraud, rather than that implied in law *1A Collier on Bankruptcy,* 14th ed. §17.17.

If a lease was arranged with the subsidiary of HALLMARK on the strength of the parent company's financial statement prepared by its accountants, the statement must have been presented for the creditor's consideration either by the parent company or on its behalf with an intent to deceive the plaintiff's financial committee and there is no evidence of such express intent either by HALLMARK'S or by any person or firm who can be considered as its agent.

The evidence presented on which this court is asked to find the defendant's conduct intentionally fraudulent is contained in a rather lengthy transcript of litigation involving the plaintiff's suit against an

accounting firm alleged to have led the plaintiff into the trap of an unwise investment. The transcript was offered by stipulation of the parties in this dispute. After having waded through some 1400 pages of that record in search of evidence in support of the plaintiff's thesis, the court was unable to find any facts leading to the conclusion that the defendant HALLMARK'S financial statement which was presented to the plaintiff as a part of the sale-leaseback transaction falls within the class of those which can be considered fraudulent because it was presented to a credulous lender with the intent to mislead. The question of the accounting firm's liability upon the grounds of negligence, not being material to the issues here, has not been examined.

Since the burden of showing by clear and convincing evidence that the defendant, HALLMARK, engaged in fraudulent activity has not been sustained, the court is of the opinion that the liability which the defendant incurred to the plaintiff by reason of its guaranty of the liability of its subsidiary U.S. CAPITAL CO'S lease from the plaintiff is a dischargeable obligation under the provisions of the Bankruptcy Act and it is therefore

ORDERED that the liability of the defendant HALLMARK CO., to the plaintiff on account of its guarantee to the plaintiff be and the same is discharged and it is further

ORDERED that any order or judgment heretofore or hereafter entered in any other court imposing any liability upon the defendant HALLMARK CO., on account

of its guaranty for the liability of its subsidiary U.S. CAPITAL CO., is and shall be void and of no effect.

Dated: NOV. 8 1978

WARREN C. MOORE

WARREN C. MOORE
Bankruptcy Judge

[FILED NOV 16 1978]

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UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA

Bankruptcy No. 574-791-M
574-792-M
(CONSOLIDATED)

In re:

HALLMARK GROUP COMPANIES INC., a New York corp.,

Debtor,

PACIFIC WESTERN MOBILE ESTATES, INC., a Delaware corp.,

Plaintiffs,

vs:

INVESTORS TAX SHELTERED REAL ESTATE LTD., DOE ONE, DOE TWO, and DOE THREE, Inclusive,

Defendants.

JUDGMENT

The above entitled matter came on for final hearing on July 12, 1978. GERALD C. VANOLI appeared for the Debtors and Plaintiffs herein and GUY BAILEY appeared on behalf of the Defendant INVESTORS TAX SHELTERED REAL ESTATE LTD. Based upon all of the evidence, oral and documentary, submitted herein, the Court finds:

1. That INVESTORS TAX SHELTERED REAL ESTATE LTD., though not listed as a Creditor in the arrangement proceedings of the Debtor herein, had actual knowledge of the arrangement proceedings in bankruptcy in this matter at a time when they could have filed a claim in these proceedings.

2. INVESTORS TAX SHELTERED REAL ESTATE LTD. did not file a claim in the above entitled arrangement proceedings prior to confirmation of the plan of arrangement.

3. That the guarantee of HALLMARK GROUP COMPANIES, INC. heretofore given to INVESTORS TAX SHELTERED REAL ESTATE LTD. cannot be excepted from its discharge because there is no pleading or evidence to support a finding of a false or misleading financial statement; further, there is no evidence that the Debtor HALLMARK GROUP COMPANIES, INC. has obtained money or property by false pretenses or false representations and there is no evidence of intentional fraud on the part of HALLMARK GROUP COMPANIES, INC.

NOW, THEREFORE, the Court orders:

That the liability of HALLMARK GROUP COMPANIES, INC. to INVESTORS TAX SHELTERED REAL ESTATE LTD. on account of its guarantee to INVESTORS TAX SHELTERED REAL ESTATE LTD. be and the same is hereby discharged; and

IT IS FURTHER ORDERED that:

Any order or judgment heretofore or hereafter entered in any other Court, including but not limited to that certain judgment entered in June of 1974 by INVESTORS TAX SHELTERED REAL ESTATE LTD. v. U. S. CAPITAL CORPORATION and HALLMARK GROUP COMPANIES, INC., No. 74-1899-E, District Court of Dallas County, Texas, 101st Judicial District, imposing any liability upon the Defendant HALLMARK GROUP COMPANIES, INC. on account of its guarantee for the liability of its subsidiary, U. S. CAPITAL CO., is and shall be void and of no effect; and

IT IS FURTHER ORDERED that:

INVESTORS TAX SHELTERED REAL ESTATE LTD. did not file a claim with this court within the time allowed by law, this court is without jurisdiction to allow the proof of such claim at this time.

DATED: NOV 16 1978

WARREN C. MOORE

WARREN C. MOORE
Bankruptcy Judge